

IN THE
United States Court of Appeals
FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.

SAMUEL GOLDWYN,
Respondent.

ON PETITION FOR REVIEW OF THE DECISION OF THE
TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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No. 12037

COMMISSIONER OF INTERNAL REVENUE,
Petitioner;

v.

SAMUEL GOLDWYN,
Respondent.

ON PETITION FOR REVIEW OF THE DECISION OF THE
TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

Jurisdiction

Samuel Goldwyn, respondent on review, is an individual residing in Beverly Hills, California. He filed his income tax returns for the taxable years 1942 and 1943 here involved with the Collector of Internal Revenue for the Sixth District of California (R. 23). By letter dated June 29, 1945 (R. 8-14), petitioner on review notified respondent that the determination of his income tax liability for the taxable year ended December 31, 1943, disclosed a deficiency of \$117,688.82. Said deficiency arises in the following manner:

Respondent in his income tax return for 1942 did not include the distribution of \$800,000.00 received by him from Samuel Goldwyn Studios, a California corporation, on the ground that it was a return of capital (R. 10). Subsequently, upon examination of said return, it was determined that the aforesaid \$800,000.00 was taxable to respondent to the extent of \$104,610.56. The adjustment was agreed to by respondent and the deficiency arising therefrom was duly paid by him (R. 14). Thereafter, the Commissioner determined that of the aforesaid distribution of \$800,000.00, \$239,059.58 constituted taxable income and increased respondent's income by that amount, which resulted in the tax deficiency of \$117,688.82 involved in this case (R. 8-14).

Within ninety days after the notice of deficiency, namely, on July 19, 1945 (R. 1), respondent filed with The Tax Court of the United States a petition for a redetermination of the aforesaid deficiency. On November 17, 1947, the Tax Court entered its decision (R. 48) that there is no deficiency for the year 1943. Within three months thereafter, namely, on February 4, 1948, petitioner on review filed his petition (R. 205-209) in this Court for a review of the decision of the Tax Court, pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

Question Presented

Did the Tax Court commit error in determining that of the distribution of \$800,000.00 made to respondent by Samuel Goldwyn Studios on December 31, 1942, the sum of \$104,610.56 constituted a distribution of accumulated earnings and profits?

Since the parties have stipulated (R. 144-145) that the amount of the 1942 distribution which constitutes accumulated earnings and profits in turn rests upon whether a dividend declared September 11, 1930, reduced accumulated

earnings and profits in the fiscal year of declaration, namely, June 30, 1931, or in the fiscal year ended June 30, 1933, the Tax Court's decision is correct if

1. The Tax Court's determination that the dividend of September 11, 1930, was, under all the circumstances of the case, constructively received by the stockholders of the declaring corporation in the fiscal year ended June 30, 1931 thereby reducing accumulated earnings and profits in that year is supported by substantial evidence and is not clearly erroneous, or if

2. The Tax Court committed no error in holding that, irrespective of the time the dividend of September 11, 1930, was received by the stockholders, the declaration of such dividend reduced accumulated earnings or profits in the fiscal year ended June 30, 1931.

Statutes Involved

Internal Revenue Code:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term “dividend” when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of

earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits.

* * *

(26 U. S. C. 1946 ed., Sec. 115.)

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term “dividend” when used in this title (except in section 203 (a) (4) and section 208 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earning or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

* * * * *

Statement of Case

In respondent's view the statement of the case made by petitioner in his brief (Pet. Br. pp. 4-13, inclusive), by confining itself to the findings of fact by the Tax Court, fails to afford a complete statement of the evidence in the record of this case. The following statement is accordingly submitted on the basis of the Tax Court's findings (R. 23-28), the stipulation of facts by the parties (R. 142-145), the exhibits (R. 145-203) and the uncontradicted testimony (R. 65-123).

Taxpayer, on December 14, 1942, acquired all the outstanding stock of Samuel Goldwyn Studios, a California corporation, formerly known as United Artists Studio Corporation (R. 142-143) and was the owner of all such stock on December 31, 1942 (R. 143). The corporation will hereinafter be referred to as “Studios” or as the “declaring corporation”.

At a special meeting of the Board of Directors of Studios on November 30, 1942, resolutions were duly adopted to reduce the par value of the capital stock of Studios from \$50 to \$10 per share, and to reduce the stated capital of Studios. These reductions produced a reduction surplus account of \$870,390.00 (R. 142-143, 145-148). It was further resolved that there be withdrawn and distributed out of said reduction surplus account to the stockholders, in cash and in property, or in either, assets of Studios in the amount of \$800,000.00 (R. 147).

In pursuance of such corporate resolutions and action, Studios, on December 31, 1942, distributed to the taxpayer the sum of \$800,000.00 (R. 143). It is the determination by the Tax Court as to what portion of this sum constitutes a distribution of earnings or profits which is the subject of this appeal.

In 1930 Studios had five stockholders, aside from the holders of qualifying shares (R. 144, 152). The stockholders were Feature Productions, Inc., Ltd.; Pickford-Fairbanks Studios; Mary Pickford Fairbanks; Douglas Fairbanks and Samuel Goldwyn, Inc., Ltd. (R. 144, 152). The controlling stockholder of Studios was Feature Productions, Inc., Ltd., a corporation engaged solely in the production of motion pictures (R. 70-71). In 1930 Feature Productions, Inc., Ltd., owned 6,491.77 shares of Studios or approximately 66% of its outstanding stock, and had control under an agreement to purchase, approximately an additional 23% of such stock, or an aggregate of approximately 90% (R. 70-71). The sole stockholder of Feature Productions, Inc., Ltd., was Art Cinema Corporation.

Studios was organized as a California corporation in 1926 (R. 74) for the purpose of acquiring, owning and making available to its stockholders, who were engaged in the production of motion pictures, studio facilities for the production of such pictures (R. 74-78). The stockholders leased office space from Studios and when engaged in the making of a picture, leased from Studios stage space, exterior lot space, various types of equipment, services

and facilities for recording sound and craft labor services (R. 78). Because of the nature of the operation of the studio it was essential that the stockholders have a close working knowledge of the operations of the studio so that they could dovetail their own production into the studio's operations (R. 77-78). All of the stockholders of Studios were represented on its board of directors and took an active part, in the affairs of the corporation in which they were vitally interested. They were well informed at all times of the operations and the financial condition of Studios (R. 78). Studios' controlling stockholder, Feature Productions, Inc., Ltd., maintained its offices on the premises of Studios (R. 78).

The board of directors of Studios consisted of the following individuals:

A. M. BRENTINGER—who was Vice President and General Manager of Studios and General Manager of Feature Productions, Inc., Ltd., Studios' controlling stockholder (R. 75)

ABRAHAM LEHR—who was Vice President, a Director and Acting General Manager of Samuel Goldwyn, Inc., Ltd., another of Studios' stockholders (R. 75)

JOSEPH M. SCHENCK—who was President of Art Cinema Corporation, the parent company of Feature Productions, Inc., Studios' aforesaid controlling stockholder (R. 75-76)

MARK FEILER—who was a relative of Joseph M. Schenck (R. 75)

N. A. MCKAY—who was business manager for Mary Pickford Fairbanks, another stockholder of Studios (R. 76)

ROBERT P. FAIRBANKS—who was President of Studios, was a brother of Douglas Fairbanks, another stockholder of Studios (R. 76)

Studios billed its stockholders for the use of labor and material on a daily basis (R. 78-79). The stockholders were

billed also on a daily basis for any equipment which was customarily rented on a daily basis. They were billed daily for the so-called production day charge, which was an over-all charge for the right and privilege of photographing on the studio premises. The stockholders were billed weekly and made payment weekly for office space and certain other items which were rented on a weekly basis (R. 79).

The stockholder-producers of Studios paid their general accounts weekly if the requirements of Studios necessitated it. If Studios did not need the funds for current operations, payments were made as the need for funds arose (R. 79).

The stockholders of Studios maintained running accounts with their corporation (R. 80). Such accounts were set up in 1930 on a picture by picture basis (R. 82). They were not so set up in the year 1933 (R. 82).

On September 17, 1930, the total indebtedness of the stockholders of Studios to that corporation was \$85,865.06 (R. 82). On December 15, 1930, the total indebtedness due from stockholders to the corporation was \$90,818.87 (R. 83).

On September 11, 1930, by resolution of its board of directors Studios declared a cash dividend of \$21.00 per share to all stockholders of record as of September 10, 1930, payable December 15, 1930 (R. 143, 150-151).

On September 17, 1930, pursuant to the aforesaid resolution of September 11, 1930, surplus of Studios was charged in the amount of the dividend and the stockholders of Studios were credited with their respective proportions of the dividend (R. 25, 144, 152). The amount actually charged to surplus was \$204,656.67, rather than \$203,091.00 the amount of the dividend, because of the erroneous inclusion of the sum of \$1,565.67 and the erroneous crediting of Samuel Goldwyn, Inc., Ltd., with the same amount. The error in the amount of \$1,565.67 was subsequently corrected by a reversing entry (R. 91).

The charge to surplus and the credit to stockholders in the amount of the dividend were unrestricted (R. 152). The stockholders knew immediately of the dividend declaration and the unrestricted crediting of the respective amounts to them through their representation on the board of directors (R. 24, 75-77), their close working relationship with the declaring corporation and their knowledge of the operations and financial status of that corporation (R. 77-78) and through the furnishing of monthly financial reports to them by Studios (R. 85, 87).

On June 30, 1930, surplus or accumulated earnings or profits of Studios was \$286,399.42 (R. 143) and on June 30, 1931, after the charge of the dividend in the amount of \$203,091.00 had been made, the earned surplus of the corporation was \$58,971.12 (R. 89, 90, 125). The net worth of Studios on July 1, 1930 was \$1,129,786.10 (R. 90). On July 1, 1931, the net worth of Studios was \$1,026,071.12 (R. 90).

Both prior to 1930 and subsequent thereto Studios was able to and did borrow substantial sums of money both from its controlling stockholder Feature Productions, Inc., Ltd. and from commercial banks (R. 90, 91).

Feature Productions, Inc., the aforesaid controlling stockholder of Studios, took its share of the dividend of September 11, 1930, as income in its taxable year in which the dividend declaration was made, namely, its fiscal year ended June 30, 1931 (R. 122), specifically identifying the dividend as having been received from Studios in Schedule H of its return in the fiscal year ended June 30, 1931 (R. 141).

No instructions as to the disposition of their respective shares of the dividend of September 11, 1930, were received from the stockholders of Studios until the fiscal year ended June 30, 1933, when the stockholders instructed Studios to apply the amounts thereof against the indebtedness of the stockholders to Studios (R. 93-94).

The parties have stipulated (R. 144-145) that if the accumulated earnings and profits of Studios were reduced

in the fiscal year ended June 30, 1931, by the sum of \$203,091.00 then, of the \$800,000.00 distributed to taxpayer by Studios on December 31, 1942, \$104,610.56 constituted a distribution of accumulated earnings or profits; that if such reduction took place in the fiscal year ended June 30, 1933, then, of the \$800,000.00, the sum of \$239,059.58 constituted a distribution of accumulated earnings or profits.

Statement of Points to be Urged

1. The determination of the Tax Court that the dividend of September 11, 1930, was, under all the circumstances of the case, distributed to the stockholders in the fiscal year ended June 30, 1931, and reduced accumulated earnings or profits of the declaring corporation in that year, is a fact determination supported by substantial evidence and is clearly correct.

2. Irrespective of the time when the dividend of September 11, 1930, was distributed, the declaration of that dividend created a liability of the corporation and correspondingly reduced accumulated earnings or profits in the fiscal year ended June 30, 1931, and the Tax Court committed no error in so holding.

Summary of Argument

The basic question presented by this appeal is whether the Tax Court committed error in finding that the earnings or profits of Studios had been reduced by the dividend declared September 11, 1930, in the fiscal year ended June 30, 1931 (R. 28). The Tax Court's determination is correct either if:

(1) The distribution of the dividend declared September 11, 1930, was, under all circumstances of this case, made in the fiscal year ended June 30, 1931, or

(2) Irrespective of the time of distribution, the unqualified declaration of the dividend on September 11, 1930, payable December 15, 1930, to stockholders of record on September 10, 1930, correspondingly reduced earnings or profits in the fiscal year ended June 30, 1931.

The taxpayer contends that

(1) The determination of when a dividend is received by stockholders is a question of fact to be resolved in the circumstances of the individual case. The Tax Court had ample evidence in this record to support its determination that the dividend was constructively received by the stockholders in the fiscal year of declaration, namely, the year ended June 30, 1931, and the decision is clearly correct. No question of law is presented on this point.

(2) The declaration of the dividend of September 11, 1930, in and of itself operated to create a liability owing by the corporation to its stockholders in the amount of the dividend and thereby reduced the corporation's accumulated earnings or profits at the time of declaration.

The basic fallacy of the Commissioner and the dissenting Tax Court minority is the assumption that Section 115(a) of the Internal Revenue Code abrogates the established rule that the declaration of a dividend requires the reduction of earnings or profits. They assume that earnings or profits are only reduced by the distribution of a dividend. Section 115(a) does not, in any respect, attempt to define earnings or profits, or to provide when or in what manner they are reduced. It merely fixes the tax liability of a shareholder upon a corporate distribution. For that purpose it provides that the term "dividend" means a distribution either out of earnings or profits accumulated after February 28, 1913, or out of earnings or profits of the taxable year computed as of the close of the year without regard to earnings or profits at the date of distribution. It does not state that a reduction of earnings is

effected only by a distribution or that there is any relationship between the two. On the contrary, it specifically provides for the computation of earnings or profits at the close of the corporation's taxable year without regard to whether there were any earnings or profits at the date of distribution.

ARGUMENT

Preliminary

As previously stated, the question for determination is what portion of the \$800,000.00 distribution received by the taxpayer in 1942 represents a distribution of earnings or profits and what portion constitutes a return of capital. The parties have stipulated that if the accumulated earnings or profits of the declaring corporation were reduced by a dividend in the fiscal year ended June 30, 1931, then, of the \$800,000.00, the sum of \$104,610.56 constituted a distribution of accumulated earnings or profits; that if such reduction took place in the fiscal year ended June 30, 1933, then, of the \$800,000.00, the sum of \$239,059.58, constituted a distribution of accumulated earnings or profits (R. 144-145).

The Tax Court found that the dividend was distributed in the fiscal year ended June 30, 1931, and that Studios' accumulated earnings or profits were reduced by the amount of the dividend (\$203,091.00) in that year (R. 28, 36). Accordingly, pursuant to the stipulation of the parties, the Tax Court found that of the \$800,000.00 received by the petitioner in 1942 the sum of \$104,610.56 constituted a distribution of earnings or profits (R. 28, 36).

I.

The determination of the Tax Court that, in the light of the undisputed evidence in the record, the dividend declared on September 15, 1930 was constructively received by the stockholders in the fiscal year of declaration, is abundantly supported by the evidence and the Tax Court committed no error in so determining.

On this point the statement of the question asserted by petitioner on review (Pet. Br. p. 2) is incorrect. To say that the main question "turns upon * * * whether that dividend (the dividend of September 11, 1930) was not 'distributed' and the earnings and profits were not reduced until the fiscal year ended in 1933, when it was actually paid," is a bald assumption of the very fact in issue. The Tax Court found that the dividend was paid to the stockholders in the fiscal year ended June 30, 1931 (R. 28, 36). Petitioner's statement that the dividend was actually paid in 1933 contradicts the Tax Court's decision. The correct question is whether the Tax Court's determination that the dividend was paid in the fiscal year ended June 30, 1931 and reduced accumulated earnings or profits of the declaring corporation in that year is supported by substantial evidence and is not clearly erroneous.

Taxpayer desires to call to the attention of this Court the fact that at the time the dissenting opinion was written the Tax Court had erroneously found that the controlling stockholder of Studios had reported receipt of its proportionate share of the dividend of September 11, 1930, in a consolidated return for 1933 instead of 1931. This error was corrected by the Tax Court, *sua sponte*, by order dated October 24, 1947 (R. 47). As corrected, the finding is that the controlling stockholder reported receipt of its share of the dividend in a consolidated return for 1931 (fiscal year ended June 30, 1931) (R. 28). The finding involved is highly material since the action of the controlling stock-

holder lends substantial support to the determination that the dividend was constructively received by the stockholders in the year of declaration.

The Commissioner agrees (Pet. Br. p. 32-33) that dividends are taxable to a stockholder as constructively received when they are unqualifiedly subject to his demand. The rule has been stated as follows:

“A charge to surplus and credit to stockholders will give rise to the distribution of a dividend if the income is thereby made unqualifiedly subject to the demand of and withdrawal by stockholders.”

Mertens, Law of Federal Income Taxation, Sec. 9.07.

To the same effect see *A. D. Saenger, Inc. v. Commissioner*, 84 F. (2d) 23 (C.C.A. 5th, 1936), cert. den. 299 U.S. 577; *W. B. Brooks*, 12 B.T.A. 31 (1928), aff'd 35 F. (2d) 178 (C.C.A. 4th, 1929), 8 A.F.T.R. 9681; *Hadley v. Commissioner*, 36 F. (2d) 543 (Ct. of App. Dist. of Col., 1929); *Eakins v. U. S.*, 36 F. (2d) 961 (E.D.N.Y., 1930); *George E. Towle*, 19 B.T.A. 208 (1930), Acq. IX-2, C.B. 65, *E. Gordon Perry*, 28 B.T.A. 497 (1933); *Jacobus v. U. S.*, 9 F. Supp. 41, 46 (Ct. Cls. 1934); *Leon S. Herbert*, 32 B.T.A. 372 (1935), aff'd 81 F. (2d) 912 (C.C.A. 3rd, 1936).

In *Lawrence, et al. v. Commissioner*, 143 F. (2d) 456 (C.C.A. 9th, 1944), this Court stated the rule of constructive receipt as follows (p. 458):

“It is true that a dividend may be taxable to a stockholder as income when it is declared, even though it be left to his credit on the corporate books and not actually paid to him. However, it is essential that the stockholder have an absolute right of withdrawal.”

The Tax Court found that in the fiscal year 1931 the dividend of September 11, 1930 was charged against surplus and that each of the shareholders was credited with his proportionate share of the amount declared as a divi-

dend (R. 25). The Tax Court determined that, in the circumstances of the case, the stockholders had thereby secured complete control of the dividend (R. 36).

The question of whether a dividend is unqualifiedly subject to the demand of a stockholder is a question of fact. Cf. *Ross v. Commissioner*, 169 F. (2d) 483, 491 (C.C.A. 1st, 1948), where Mr. Justice Frankfurter, sitting as a Circuit Justice, stated:

“We need not determine here whether or not, in the light of the restrictive agreements and the financial status of the corporation, petitioner’s accrued salary was unqualifiedly subject to his demand in the years 1927 through 1932. These are questions of fact to be determined by findings of the Tax Court.”

The Commissioner is wrong in stating (Pet. Br. p. 26) that the case at bar, unlike *Commissioner v. Rainier Brewing Co.*, 165 F. (2d) 217, rehearing denied, 166 F. (2d) 324; *Seattle Brewing Co. v. Commissioner*, 165 F. (2d) 216, rehearing denied, 166 F. (2d) 326; and *Schweppe v. Commissioner*, 168 F. (2d) 284, “presents a pure question of law as to the proper interpretation or meaning of the statute, in the light of undisputed facts.”

Section 1141 of the Internal Revenue Code, as amended, gives the Circuit Courts of Appeals jurisdiction to review decisions of the Tax Court in the same manner and to the same extent as the decisions of the district courts in civil actions tried without a jury. Reviewability of district court decisions is governed by Rule 52(a) of the Federal Rules of Civil Procedure, in effect September 16, 1938 which reads in part as follows:

“Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses.”

The scope of "clearly erroneous" has been considered by this Court on numerous occasions. The holdings cover a wide range of lower court findings. The general rule is that the finding is presumptively correct and stands unless some obvious error of law has intervened or a lack of substantial evidence exists, *Wingate v. Bercut*, 146 F. (2d) 725 (C.C.A. 9th, 1944); *Alexander v. Johnston*, 137 F. (2d) 712, 713 (C.C.A. 9th, 1943), and cases cited therein; *Ralph N. Brodie et al. v. Hydraulic Press Mfg. Co.*, 151 F. (2d) 91 (C.C.A. 9th, 1945).

In *Lawrence v. Commissioner*, 143 F. (2d) 456 (C.C.A. 9th, 1944), this Court in considering the question of constructive receipt of a dividend stated (143 F. (2d) at page 459):

"Petitioners point out various circumstances that would suffice to support a finding to the contrary. We do not consider them. When the findings of the Tax Court are supported by substantial evidence we have no power to consider the relative weight of evidence to the contrary. *Wilmington Trust Co. v. Helvering*, 316 U.S. 164, 168, 62 S. Ct. 984, 86 L. Ed. 1352."

The determination by the Tax Court that, under all the circumstances of the case, the dividend of September 11, 1930, was constructively received by the stockholders of Studios in the fiscal year ended June 30, 1931, is supported by substantial evidence and the Court committed no clear error with respect to such determination. The entries of September 17, 1930, charging the surplus account of Studios with the amount of the September 11, 1930 dividend and crediting the stockholders proportionately with the amount of the dividend were without limitations, qualifications or restrictions (R. 152-156). The undisputed evidence is that at that time Studios was a closely held corporation (R. 152) consisting in substance, as the Commissioner recognizes (Pet. Br. p. 7), of Feature Productions, Inc., Ltd., Samuel Goldwyn, Inc., Ltd., Mary Pickford and Douglas Fairbanks.

All of such stockholders were engaged in the production of motion pictures; and Studios had been organized to furnish studio facilities for such production (R. 75). The business activities of Studios were closely integrated with those of its stockholders (R. 70-78). All the stockholders were represented on the corporation's board of directors (R. 24, 77) and had been so represented at the meeting at which the dividend was declared (R. 150). All the stockholders took an active part in Studios' affairs (R. 24, 77) and were well informed of the operations and the financial condition of the corporation at all times (R. 78), as the nature of their relationship in fact required (R. 77, 78).

Studios' controlling stockholder, Feature Productions, Inc., Ltd., owning outright about 66% of Studios' outstanding stock and having under agreement the right to purchase an additional 23% of said stock, or an aggregate of about 90% thereof (R. 70-71), maintained its offices on the premises of Studios (R. 70). In addition, periodic financial reports were issued by Studios to its stockholders at intervals of not less than a month or more frequently if requested by a stockholder (R. 85).

The entire picture is one of a closely held, well-integrated, cooperative enterprise, in which the stockholders were required to and did exercise a complete control over the conduct of the affairs of their corporation, wherein they participated through their representatives in declaring the September 11, 1930 dividend payable December 15, 1930, wherein the corporation was able to pay the dividend, and wherein also, following the declaration, the dividend was charged against surplus, was unrestrictedly credited to the individual stockholders proportionately, and was unqualifiedly available to them. The fact that they did not direct the disposition of the dividend until 1933 is immaterial.

Constructive receipt has been found in cases which are weaker factually than the instant case, and in some of such cases the Commissioner has acquiesced in the decisions.

In *E. Gordon Perry*, 28 B.T.A. 497, (1933) where a husband and wife owned 80% of the capital stock of the declaring corporation of which the husband was president, a crediting of the husband's account with the corporation and a debiting of the corporation's surplus account was held by the Tax Court (then the Board of Tax Appeals) to constitute a distribution of the dividend, despite the fact that the dividend was not actually withdrawn until a subsequent taxable year. The husband and wife had reported the dividend in their returns and maintained that the dividend was constructively received in the year of crediting. The Commissioner maintained that there was no receipt until actual withdrawal. Yet in that case there were no findings as to the actual control exercised by either spouse over the corporation; or as to their knowledge of the operations of the corporation; or as to any factors other than stock ownership and the entries charging surplus and crediting the husband's account.

In *George E. Towle*, 19 B.T.A. 208, (1930) the petitioner and another individual each owned 50% of the stock of a corporation. Following the incorporation petitioner and his associate agreed that the profits and losses should be determined and delivered monthly and that the proportionate share thereof should be credited or charged to the personal account of each of the two owners on the books of the corporation. Petitioner did not include his share of the profits so credited on the books in his return for the taxable year of crediting. The credits, as here, were unrestricted. Petitioner was a director and treasurer of the corporation. The Tax Court (then the Board of Tax Appeals) held on these facts that (p. 212)

“Under the facts before us we feel that it is apparent that his share of the earnings of the corporation was unqualifiedly subject to the demand of the petitioner from the times in the several years when determined and divided according to the books.”

The Commissioner acquiesced in this case (Acq. IX-2, C.B. 65). Here again there is a finding of control from a crediting in a closely held corporation without a development of specific evidence of control, aside from the offices held by the taxpayer. There was no declaration of a dividend in Towle and apparently no charge to surplus in the amount thereof.

In *Valley Lumber Co. of Lodi*, 43 B.T.A. 423, (1941) the petitioner was a close corporation with eight stockholders, operating on an accrual basis. In 1936 it declared two dividends, one on September 5, the other on December 24, both payable at once. All of the stockholders had accounts on the corporation's books but none was indebted to the corporation. The amounts of the dividends were immediately credited to the stockholders' accounts; the first dividend was withdrawn but the second dividend remained undrawn in the several accounts for the remainder of the year. Six of the stockholders included the entire amount of both dividends in their 1936 income; one included only the September dividend; and one filed no return. The question of constructive payment of the dividend arose with respect to the dividends paid credit. The Tax Court held that the credit was allowable, stating the rule to be as follows: (p. 426)

“When a book credit is unrestricted and thoroughly subject to the demand and control of the shareholder, it is the equivalent of cash and does constitute payment of the dividend for the purpose of the dividends paid credit.”

There is nothing in the record of the *Valley Lumber Co. of Lodi, supra*, which indicates that the relationship existing between the stockholders and the corporation was as close as here; or that the stockholders were represented on the board of directors of the declaring corporation, as is true in the instant case; or that the stockholders exercised the day by day control over their corporation which the stockholders of taxpayer exercised in the instant case. The

only finding was that the corporation involved had eight shareholders and was a close corporation. The Commissioner acquiesced in the decision (1941-1 C.B.11).

While purporting to agree with the rule of the foregoing cases (Pet. Br. p. 33), the Commissioner maintains that important elements of constructive receipt are here lacking. He states (Pet. Br. pp. 33, 34) that this court has definitely recognized that a "segregation" must be made in order that a dividend may be regarded as constructively received and that the stockholder must have acquired control over the dividend. He denies that there is any evidence of either a segregation or control. The contention approaches casuistry.

In the case referred to by the Commissioner, *Commissioner v. Scatena*, 85 F. (2d) 729, (C.C.A. 9th, 1936) a dividend was declared in stock of another company. On November 1, 1928, the shares of dividend stock were delivered to the transfer agent of the corporation in whose stock the dividend had been declared. On October 31, 1928, the declaring corporation charged its surplus with the cost of the dividend shares. The date on which the certificates for the dividend shares were delivered was not in the record. Nevertheless this court held that the intention of the declaring corporation was that (p. 729)

"title to the dividends passed at the time of declaration or, at the latest, at the time of delivery of the certificates to the transfer agent."

It recognized the general rule that (p. 731)

"the lawful declaration of a dividend creates a debt from the corporation to the stockholders, and when a segregation is made to the amount of the dividend, the amount thereof is held by the corporation as trustee for the stockholders."

This court did not attempt in the *Scatena* case to define a "segregation". There is ample authority, however, for

the proposition that the mere declaration of a dividend effects the segregation. In *McLaran, Admin. v. Crescent Planing Mill Co.*, 117 Mo. App. 40, 49 (1906) the court stated:

“The doctrine is that by the mere declaration the dividend becomes immediately separated and segregated from the stock and exists independently of it; that the right thereto becomes at once immediately fixed and absolute in the stockholder, and from thenceforth the right of each individual stockholder is changed by the act of declaration from that of partner and part owner of the corporate property to a status absolutely adverse to every other stockholder and to the corporation itself, in so far as his pro rata proportion to the dividend is concerned.”

The Court of Claims states the rule as follows in *Bulger Block Coal Co. v. U. S.*, 48 F. (2d) 675, 678 (Ct. Cls. 1931):

“These cases show that authority is abundant for the proposition that the declaration of a dividend is sufficient by itself and alone to set apart from the profits of the corporation (if the profits are sufficient for that purpose) a sum which is to be paid to stockholders in proportion to their shares.”

The rule is stated as follows in 18 C.J.S. Sec. 463, p. 1104:

“The declaration of a dividend is the act of the corporation in setting apart a portion of its net or surplus profits for distribution among the stockholders according to their respective interests.”

The Tax Court has stated it as follows in *The Gregg Company*, 25 B.T.A. 81, 89 (1932):

“A corporation may declare a dividend whenever it has surplus profits equal to or greater than the amount of the dividend. The fact that it does not have ready cash with which to pay does not render the dividend illegal. *Gilbert Paper Co. v. Prankard*, 198 N. Y. S. 25; *Cox v. Leahy*, 204 N. Y. S.

741. *Upon the declaration of a dividend a corporation becomes the debtor of the stockholder for his proportionate part thereof, and the amount of the dividend is no longer a part of the company's assets. W. E. Caldwell Co., 6 B.T.A. 47; Zenith Milling Co., 8 B.T.A. 1279; affd. 41 Fed. (2d) 905; Georgia Engineering Co., 21 B.T.A. 532.*" (Italics supplied)

Moreover, obviously, the unconditional charge to surplus and credit to the individual stockholders in their proportionate shares of a dividend is a sufficient segregation in a proper case to make the dividend available to stockholders and to support taxation thereon as a dividend distributed in the year of the crediting. *Baker v. U. S.*, 17 F. Supp. 976 (Ct. Cls. 1937); *Jacobus v. U. S.*, 9 F. Supp. 41 (Ct. Cls. 1934); *Hadley v. Commissioner*, 59 App. D. C., 139, 36 F. (2d) 543 (1929); *Brooks v. Commissioner*, 35 F. (2d) 178 (C.C.A. 4th, 1929); *A. D. Saenger, Inc. v. Commissioner* 84 F. (2d) 23 (C.C.A. 5th, 1936), cert. den. 299 U.S. 577. It is the reduction of accumulated earnings or profits by the charge to surplus and the crediting of the amount of the reduction without restriction to the stockholders which in the proper factual frame will effect the distribution.

The case of *Frederick Smith Enterprise Company v. Commissioner*, 167 F. (2d) 356 (C.C.A. 6th, 1948), is cited by the Commissioner (Pet. Br. p. 34) apparently for the proposition that the existence of indebtedness owing by the stockholders to the corporation does not effect a payment of a dividend by way of offset. This case is cited as having been decided by this circuit. It was in fact decided by the Sixth Circuit.

In the first place, this case involves the question of whether a dividend was "paid" within the time delimited by Section 504(c) of the Internal Revenue Code. It had nothing to do with the question of when the dividend reduced earnings and profits of the declaring corporation. In

the second place, the Commissioner has failed to include in his statement of the facts of the case material facts which indicate that the situation is not at all comparable to the instant case. These facts are as follows: (1) the checks in payment of the dividend were issued on March 26, eleven days after the expiration of the period prescribed in section 504 (c) had expired, and were delivered on that date. They were then returned to the company to apply upon the stockholders' accounts. (2) There was no evidence of any agreement between the stockholders and their corporation whereby the indebtedness of the stockholders to the corporation was offset against the dividend obligation of the corporation. (3) No book entries were made reflecting a set-off. Because of these facts the Tax Court had rejected the contention of payment by offset (Tax Court Memo. Op. Docket No. 11158) and the Circuit Court affirmed.

The Commissioner (Pet. Br. p. 33) cites *The Korfund Co., Inc. v. Commissioner*, 1 T.C. 1180 (1943), apparently as being a case which resembles the case at bar and in which constructive receipt was denied. The case is readily distinguishable on its facts. In that case there was a stockholders' agreement "specifically providing against making the dividend subject to their demands except by mutual consent." There was no crediting to the accounts of the stockholders of the amount of the dividend. The dividend had not been charged against surplus of the declaring corporation in the year claimed as the year of constructive receipt. The evidence did not show, and petitioner made no contention, that any of the stockholders reported his proportionate part of the surplus as income from dividends in the year of claimed constructive receipt. It is quite apparent that the *Korfund* case bears no factual resemblance to the instant case.

The Commissioner contends (Pet. Br. p. 34, 35, 37) that no significance should be given to the entry debiting surplus and crediting the individual stockholders proportionately.

He states (Pet. Br. p. 24, 25) that the corresponding credit was to a dividends payable account and that the account still left the dividends unpaid. The Commissioner is in error. The credit (See Exhibit 3-C, R. 152) was to individual stockholders in pro rata amounts under a heading reading "Dividends Payable." The Tax Court found that each stockholder was credited with his proportionate share of the amount declared as a dividend in the Dividends Payable account (R. 25) and that the crediting to the stockholders was sufficient to constitute payment of the dividends (R. 36). While the *Dobson* case has lost the magic of its reviewability holding, it may still be said to indicate that the Tax Court is not nearly as inept at accounting problems as the Commissioner's brief would seem to imply.

A similar contention was made in *Bulger Block Coal Co. v. U.S.*, 48 F. (2d) 675 (Ct. Cls. 1931), in which the Commissioner had excluded from invested capital of a dividend declaring corporation an amount representing the balance of a credit on the books of the corporation of a stockholder's proportionate share of the dividend, the account reading "Dividends Payable—D. J. Kennedy," which is in all material respects similar to the entry which the Commissioner is here attacking. The amount of the credit was \$104,950.00. The taxpayer contested that treatment, contending, *inter alia*, that the bookkeeping entries were insufficient to effect a payment of the dividend. The shoe was on the Commissioner's other foot in that case—he supported the entry there.

The court ruled that the amount of the dividend credit was borrowed capital to be excluded from the declaring corporation's invested capital since the declaration had reduced the surplus of the corporation by creating a liability of the corporation to its stockholders and its use of the funds with which it was required to pay the dividend was a use of borrowed capital.

On the point of the sufficiency of the book entry the court stated (681):

“We think, we have already shown quite conclusively, that the declaration of a dividend is by itself and alone sufficient to set apart the amount thereof to the stockholders, but, if it should be held that some other segregation should be made thereof in order to take the fund out of the surplus account, we think it was done in this case when the amount of the dividend in controversy was, after the declaration of the dividend, carried on plaintiff’s books in an account headed ‘Dividends payable—D. J. Kennedy.’ The plaintiff calls attention to the fact that a portion of the dividend due D. J. Kennedy was credited directly to his personal account. The evidence fails to show why this was done, and we do not think it alters the relation of the parties.”

Assuredly, a book entry, standing alone, may be insufficient to effect a distribution of a dividend; but when that book entry is complete and unreserved and the context in which such entry is made is a closely held corporation whose stockholders actively participated in the conduct of the corporate enterprise and exercised a complete day-by-day control over their corporation in order that their business activities might be meshed and integrated with the activities of the corporation, as the nature of the business of both required, and where the stockholders, without any additional action on the part of the declaring corporation, were able in 1933 to direct the disposition of the dividend, it is clear that the control was in fact present in the fiscal year of declaration. In addition, the action of the controlling stockholder in reporting the receipt of the dividend in the fiscal year of declaration, namely, the fiscal year ended June 30, 1931, is a significant recognition of the complete availability of the dividend in that year.

There is no substance to the Commissioner’s argument here (Pet. Br. pp. 35-36) that the control exercised in 1933

does not evidence the prior existence of such control because the date on the journal entry (May 27, 1933) precedes the date on the letters of authorization from the stockholders, to wit: June 27, 1933. The entry dated May 27, 1933 (R. 154) refers to the letters of authorization of June 27, 1933 as authorizing the entry itself. Obviously, the date of the journal entry is not the day upon which the journal entry was made and at the time of such entry it was based upon and reflected the directions of the stockholders. The control which they exercised in the fiscal year ended June 30, 1933 was the control which they had in the fiscal year ended June 30, 1931. What they did in the fiscal year ended June 30, 1933, they could have done in the fiscal year ended June 30, 1931, and in the intervening fiscal years as well. That they did not do so does not lessen one whit the fact that the dividend was constructively received in the fiscal year ended June 30, 1931 and the Tax Court committed no error in so holding.

The control of the stockholders in the case at bar over Studios, the declaring corporation, was complete and the Tax Court committed no error in finding that the stockholders could have withdrawn the dividend in the fiscal year of declaration and that it was unqualifiedly subject to their command in that year. To say, as petitioner does, (Pet. Br. p. 34), that "under the facts of this case there was no control, as a matter of law." is to evince a lack of regard for the undisputed realities of the case. The case is thoroughly impregnated with the evidence of the control.

II.

Irrespective of the time when the stockholders received the dividend, the declaration of the dividend on September 11, 1930, payable December 15, 1930, created a liability of the corporation and correspondingly reduced the then accumulated earnings or profits, and the Tax Court committed no error in so holding.

This point is moot if the Tax Court's determination that the dividend of September 11, 1930, was under all the circumstances of the case constructively received by the stockholders of the declaring corporation in the fiscal year ended June 30, 1931, thereby correspondingly reducing accumulated earnings and profits in that year.

The parties have stipulated (R. 144-145) that the taxability of the dividend distribution in 1942 depends upon whether the accumulated earnings or profits of Studios were reduced in the fiscal year ended June 30, 1931, or in the fiscal year ended June 30, 1933. The rationale of the Tax Court's opinion on this point is that upon the declaration of the dividend Studios became legally bound in the fiscal year 1931 to pay the declared dividend to its stockholders; that this amount could no longer be listed among its assets but represented an indebtedness; and that surplus was thereby decreased (R. 30-33).

The gist of the Commissioner's contention, as nearly as it can be gleaned from petitioner's brief, is that, because Section 115(a) of the Internal Revenue Code and of the Revenue Act of 1928 defines a dividend as a distribution "out of" accumulated earnings or profits, such earnings or profits could not be reduced until the distribution of the dividend by actual or constructive payment (Pet. Br. p. 19). In other words the Commissioner is contending that Section 115(a) abrogates the general rule that the earnings or profits of a corporation are reduced by the declaration of a dividend.

There is no magic in the term "distribution" as used in Section 115(a) of the Internal Revenue Code or in the Revenue Act of 1928. Such section merely defines the time when and the extent to which a stockholder of a corporation is subject to tax as the result of a corporate distribution. It makes no reference to a reduction of earnings or profits. On the contrary, as will hereinafter be pointed out, Section 115(a) now defines a dividend as a distribution out of current earnings of the taxable year computed as of the close of the year without regard to whether there were earnings or profits at the date of distribution.

Under long established and uniform holdings of the courts, earnings or profits are reduced at the time of the declaration of a dividend. At such time an enforceable debt is created by the corporation to its stockholders in the amount of the dividend and earnings or profits of the corporation are segregated to the extent of the dividend and are appropriated to the stockholders. The ensuing distribution effects no reduction of earnings or profits; it merely constitutes the transfer of the funds which have been appropriated and already withdrawn from earnings or profits. It is a distribution of funds previously taken from earnings or profits and which are "out of" earnings or profits. The Commissioner's conclusion that earnings or profits could not be reduced prior to a distribution because the Internal Revenue Code provides that a dividend is a distribution "out of" accumulated earnings or profits, is a complete *non sequitur*.

The question here involved is not the liability to tax of the stockholders as the result of a declaration of the dividend of September 11, 1930. The question to be determined in accordance with the stipulation of the parties is the narrow question of whether the declaration of such dividend reduced accumulated earnings or profits. Thus, the question is a corporate question and not a stockholder-taxability question and cases like *Tar Products Corp. v. Commissioner* 130 F. (2d) 866 (C.C.A. 3rd, 1942); *Mason v. Rout-*

zahn, 275 U.S. 175, 48 S. Ct. 50 (1927); and *Emily D. Proctor*, 11 B.T.A. 235 (1928), and other cases cited by the Commissioner (Pet. Br. p. 19, 20) which treat of taxability of dividends from the point of view of the individual stockholder, are not germane to the issue here presented.

The fallacy in the Commissioner's arguments will be found in his confusing endeavor to apply rules governing stockholders' income taxability in the solution of what is strictly a corporate problem, namely, when surplus was reduced.

The Commissioner's statement (Pet. Br. p. 19) that it is "the settled rule that it is the distribution or payment of a dividend, and not the declaration, which governs for tax purposes" is erroneous. The date of declaration and not the date of distribution controls where questions of reducing a corporation's invested capital because of a dividend are involved (*The Gregg Company, Ltd.*, 25 B.T.A. 81 (1932); *Belmont Iron Works*, 9 B.T.A. 216 (1927); *W. E. Caldwell Co.*, 6 B.T.A. 47 (1927); or where the status of the amount of a declared dividend as borrowed capital until paid is involved (*Bulger Block Coal Co. v. U.S.* 48 F. (2d) 675 (Ct. Cls. 1931). In speaking of the question of the effect of the declaration of a dividend on the statutory invested capital of the declaring corporation, the Tax Court stated in the *Caldwell* case, *supra*, that that problem "has nothing to do with the time at which the distribution results in income to the distributee, or the rates at which it is taxable to him." (6 B.T.A. at p. 50)

The established rule on the effect of the declaration of a dividend is, as this court has recognized (*Commissioner v. Scatena*, 85 F. (2d) 729, 731) (C.C.A. 9th, 1936), that upon the declaration of a dividend the funds represented by the dividend are separated from the accumulated earnings or profits of the corporation and are appropriated by that action to the stockholders benefited by the declaring resolution who become creditors of the corporation for the amount of the dividend. So far as the dividend itself is

concerned, the relationship of corporation and stockholders has ceased and the relationship of debtor and creditor has been created. It is immaterial that the dividend is made payable at a later date. The rights of the stockholders as creditors are vested immediately upon the declaration of the dividend. The unconditioned title to the money or property actually vests as a matter of law in the stockholders at that time. *Fletcher, Cyc. Corps.* Sec. 5322, p. 786. When such a dividend has once been declared it cannot be rescinded. *Commissioner v. Scatena*, supra, at page 731, *Fletcher Cyc. Corps.*, Sec. 3653, page 6064.

The rule is stated in *U. S. v. Guinzburg*, 278 Fed. 363 (C.C.A. 2nd, 1921): as follows:

“By the declaration of a dividend, the earnings of the company to the extent declared were separated from the property of the corporation, and were appropriated by that action to the then stockholders, who became creditors of the corporation for the amount of the dividend. The relation then created was that of debtor and creditor. *N. Y. Trust Co. et al v. Edwards, Collector*, 257 U.S. 176, 42 Sup. Ct. 68, 66 L. Ed. 186, decided November 21, 1921; *Wheeler v. Northwestern Sleigh Co.* (C.C.) 39 Fed. 347; *People ex rel. U. S. Trust Co. v. Barker*, 86 Hun, 131, 33 N. Y. Supp. 388; *Billingham v. Gleason Mfg. Co.*, 101 App. Div. 476, 91 N.Y. Supp. 1046, affirmed 185 N.Y. 571, 78 N.E. 1099. It is the separation of the earnings from the balance of the corporate property, together with the promise to pay arising from the declaration of the dividend, that works this change. The holder of stock, with respect to the dividend, is on a par with the other creditors of the corporation. *Staats v. Biograph Co.*, 236 Fed. 454, 149 C.C.A. 506, L.R.A. 1917 B, 728. The fact that the dividend is payable at a future date does not alter the rights thus created. The obligation of the corporation as debtor commences with the declaration of the dividend, although the payment is postponed for the convenience of the company. The rights of the stockholders are immediately vested the moment the dividend is

declared. *N. Y. Trust Co. v. Edwards*, supra. The action of the board of directors is the appropriation of a portion of the earnings to the defendant in error as the holder of a certificate of stock.”

The rule that the date of declaration and not the date of payment governs in determining the time when the dividend reduces accumulated earnings or profits is in accord with the principles of accounting. As set forth in *W. A. Paton, Accountants' Handbook*, Third Edition, pages 1041, 1042, the rule is expressed as follows:

“EFFECT OF DECLARATION OF DIVIDENDS.—When a quorum of the board of directors has resolved to appropriate an amount as dividends on a class of stock, and the shareholders of that class have been notified explicitly or constructively, the proportionate amounts applicable to the shares of the several stockholders become contractual debts of the corporation. Recognition should be given the changed relationship indicated by the amount of the dividend by charging current earnings (or a ‘dividend charges’ account which will be closed to current income) or earned surplus and crediting a dividends payable account.

Dewing (*Financial Policy of Corporations*) and Montgomery (*Auditing Theory and Practice*) accept the declaration of the dividend by the board of directors as the act which creates a debt of the corporation to its shareholders.”

The same rule is laid down by the Securities and Exchange Commission in prescribing a uniform system of accounts for commercial and industrial companies and for holding companies. The Commission requires that “dividends declared” be set up as a current liability of the declaring corporation and as a deduction from surplus. Regulations S-X of Securities and Exchange Commission, Art. 5 Rule 5.02, Subdiv. 25, 3 C.C.H. Federal Securities Law Service, par. 69242; and par. 70311.

The Commissioner admits the general rule and that California conforms to it (*Meyers v. El Tejon Oil and Re-*

fining Co., 29 Cal. (2d) 184, 174 P. (2d) 1 (1946); *Smith v. Taecker et al.*, 133 Cal. App. 351, 24 P. (2d) 182 (1933) but states (Pet. Br. p. 22) that such fact "should not be controlling in resolving the federal tax question involved here." The rule as to the corporate reduction of earnings or profits upon the declaration of a dividend is as much a part of federal income taxation as the rule for individual stockholder taxation on corporate distributions. *The Gregg Company, Ltd. v. Commissioner*, supra; *Belmont Iron Works v. Commissioner*, supra; *W. E. Caldwell v. Commissioner*, supra; *Bulger Block Coal Co. v. U. S.*, supra.

The citation of *Faris v. Helvering*, 71 F. (2d) 610 (C.C.A. 9th, 1934), cert. den. 293 U.S. 584, for the proposition that the law of California, which conforms to the general rule on the effect of the declaration of a dividend on corporate surplus, "should not be controlling in resolving the federal tax question involved here" (Pet. Br. p. 22) is wholly misleading. That case did not involve the question as to whether corporate surplus should be reduced at the time of the declaration of a dividend. It merely held that, for the purpose of determining whether an amount paid by a corporation to a stockholder is a dividend or represents capital, "neither the action of the state commissioner of corporations nor of the corporation is decisive of the matter, which is controlled by the Revenue Laws of the United States" (71 S. (2d) at page 611). Taxpayer does not deny the validity of that observation. The *Faris* case is governed by Section 201 (a) and (b) of the Revenue Act of 1921, the predecessor of present Section 115(a) of the Internal Revenue Code. The point involved in the case at bar is not controlled by Section 115(a) of the Internal Revenue Code, or by its predecessor sections.

This court in *Commissioner v. Scatena*, supra, recognized and applied the rule relating to the intra-mural effect of the declaration of a dividend in a case involving a review of a Tax Court determination of a deficiency in federal income tax determined by the Commissioner.

The basic distinction between the question of the reduction of corporate surplus by the declaration of a dividend and the question of the taxability of the stockholders with respect to a corporate distribution is made by the Tax Court in the very case which the Commissioner presses upon this court as involving "the exact question presented in this case." (Pet. Br. p. 26), namely, *Proctor v. Commissioner*, 11 B.T.A. 235 (1928). The Tax Court in the instant case stated that its prior decision in the *Proctor* case had no application to the present case because "we are not concerned with the taxability of the dividend declared on September 11, 1930, in the hands of the stockholders, but only with the effect of that dividend on corporate surplus." (R. 33).

Furthermore, the Tax Court stated that the distinction in issues was recognized in the decision in the *Proctor* case, quoting the following language (R. 33):

"***we think it beside the point that the corporation may for a profit and loss statement or accounting purposes, or as showing the status existing between the corporation and its shareholders, show its earnings and profits to be reduced by a declaration of a dividend not then paid. The dividend declared must give way to the dividend paid *in so far as the taxability of the same in the hands of the stockholders is concerned*. It is to tax that which is first distributed by payment rather than declaration that the statute seeks to and does reach. [Italics supplied]."

The Commissioner is, therefore, clearly in error when he states (Pet. Br. p. 25) that "The majority of the Tax Court in this case, however, declined to follow the *Proctor* case, perhaps because it misunderstood it, since it seemed to regard the *Proctor* case as one of 'those cases' which did not involve 'the effect of the declaration or payment [of a dividend] on the corporation's own financial structure'."

The Commissioner makes the transparently wrong argument that it is unsound and illogical to have one rule for determining when a stockholder is taxable on a dividend and another rule for determining when earnings or profits are reduced and that the tax consequences of a dividend should be the same both as to the corporation and its stockholders (Pet. Br. p. 21). Such differences present nothing either unsound or illogical. One rule is essential to determine stockholders' taxability on corporate distributions and the other to determine the corporate problem when corporate surplus is reduced. Each rule has its value in the separate situations in which it is applicable.

There is no necessary relationship between a corporate distribution and a reduction in earnings or profits. Section 115 (a) of the Internal Revenue Code provides for the taxation of a distribution which is made "out of the earnings or profits of the taxable year * * * without regard to the amount of the earnings and profits at the time the distribution was made." Section 115(b) provides that every distribution is deemed to be made "from the most recently accumulated earnings or profits". Therefore if there are no accumulated earnings or profits and no current earnings at the time of distribution, there is obviously nothing which can be reduced at the time of distribution. If thereafter, and within the same taxable year, earnings or profits are realized, then the reduction must take place at a point of time after the date of distribution. Conversely, there may be a capital deficit at the beginning of the taxable year, earnings or profits at the date of distribution, and a net operating loss thereafter which eliminates the earnings or profits by the close of the taxable year. If the Commissioner's position is right and the distribution reduces the earnings or profits, then the distribution would be a taxable dividend. But since Section 115(a) says that the earnings or profits must be computed at the close of the taxable year without regard to the earnings or profits at the date of distribution, the distribution would not be a taxable dividend.

There is, accordingly, nothing to sustain the Commissioner's argument that the date of distribution is the date at which the earnings or profits of the declaring corporation are reduced. He has mistaken Congress' designation of the sources of corporate funds upon which dividend taxation can be sustained for a legislative abrogation of long-established legal principles which were not involved in the situation upon which Congress was legislating.

The Commissioner attempts to bring to his support the treatment of earnings or profits under Section 115(h) of the Internal Revenue Code (Pet. Br. p. 21). The situation covered by Section 115(h) differs radically from the issue here involved. That section relates to exchanges, and distributions of stock or securities in connection with exchanges, in which gain is realized but is not recognized for the purposes of immediate taxation. The *Bedford, Wheeler* and *Munter* cases cited on page 21 of petitioner's brief add nothing to the discussion here.

In addition, Section 115(h) of the Internal Revenue Code was not inserted in the Revenue Act of 1936 for the purpose of adding a consistency to the law not theretofore present but was enacted for the purpose of greater clarity. The report of the Ways and Means Committee so states specifically.

“While making no change in the rule as applied under existing law, the recommended amendment is desirable in the interests of greater clarity.” House Rep. No. 2475, 74th Cong. 2nd Sess.

Irrespective of the time when the stockholders of Studios received the dividend of September 11, 1930, the declaration of that dividend created a liability of the corporation and effected a corresponding reduction of accumulated earnings or profits in the fiscal year ended June 30, 1931, and the Tax Court committed no error in so holding.

CONCLUSION

Respondent respectfully submits that the Tax Court committed no error in its determination that, of the sum of \$800,000.00 distributed to respondent in the taxable year here involved, \$104,610.56 constitutes a distribution of accumulated earnings or profits. The decision of the Tax Court should be affirmed upon either or both of the following premises:

1. The determination of the Tax Court that the dividend of September 11, 1930, was, under all the circumstances of the case, distributed to the stockholders in the fiscal year ended June 30, 1931, and reduced accumulated earnings or profits of the declaring corporation in that year, is a fact determination supported by substantial evidence and is clearly correct.

2. Irrespective of the time when the dividend of September 11, 1930, was distributed, the declaration of that dividend created a liability of the corporation and effected a corresponding reduction in accumulated earnings or profits in the fiscal year ended June 30, 1931, and the Tax Court committed no error in so holding.

Respectfully submitted,

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